This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 02 ISTANBUL 001371

SIPDIS

SENSITIVE

STATE FOR E, EUR/SE AND EB/IFD
TREASURY FOR INT'L AFFAIRS -- MILLS AND SCHWARZMAN
NSC FOR MBRYZA AND TMCKIBBEN

E.O. 12958: N/A
TAGS: ECON EINV EFIN TU
SUBJECT: ISTANBUL ANALYSTS ON CURRENT ACCOUNT RISKS

Sensitive but Unclassified. Not for internet distribution.

¶1. (SBU) Summary: Despite positive international and domestic developments, including the Turkish government's recognition of the need for a new stand-by agreement for the 2005-2007 period, Turkish markets have remained range-bound in recent weeks. Many analysts attribute the markets' failure to rally to concern about the burgeoning Turkish current account deficit, which grew 95 percent year-on-year in the first six months of 2004 and at 9.9 billion for that period is now approaching 4 percent of GDP. Most analysts doubt the deficit is near crisis levels; however, there is some difference of opinion on the severity of the problem, as can be seen by the contrasting positions rating agencies such as S and P, Fitch, Moody's, and JCR have taken. Istanbul market observers we have canvassed in recent weeks agree that the high level of the current account is the largest cloud on Turkey's economic horizon, but largely concur with Fitch and S and P that it has not yet reached crisis proportions. They argue instead that currently projected levels are financeable, and that the government's attention to the problem, while unlikely to be effective in and of itself, sent an important message to the markets that it was monitoring the issue, a point Economics Minister Babacan reiterated on August 25. End summary.

¶2. (SBU) A dramatic jump: January to June 2004 figures showed the current account gap at 9.9 billion USD, a 95 percent jump from the 5.09 billion USD deficit in the same period in 2003. While exports have grown quickly, imports have expanded even more rapidly, leaving the trade deficit at 12.2 billion USD. (The trade deficit continued to worsen in July, when it reached 3.2 billion USD.) Other negative items include investment, whose deficit was 2.8 billion USD for January to June. On the positive side of the ledger, services (largely tourism) were in surplus at 3.5 billion, as were transfers (from Turks living abroad) at 1.6 billion. As is typically the case in Turkey, tourism revenues are bunched in the third quarter, such that the full-year current account deficit may not be much higher than the first half number. For the first half, Turkey financed the overall current account gap with net capital inflows of 9.4 billion USD and (given an increase in official fx reserves of 2.7 billion USD) 3.2 billion in net errors and omissions.

¶3. (SBU) Financing Concern: Indeed, more than the absolute level of the deficit, the financing mix on which Turkey relies was of more concern to our interlocutors. Global Securities' Cem Akyurek, for instance, told us on August 19 that he sees an encouraging trend towards repatriation of foreign capital by Turkish businesses in the net errors and omission total, but finds the overall composition of Turkey's capital inflows less inspiring, particularly the country's reliance on "hot money," i.e. short-term portfolio investment. Indeed, figures show that of the net inflow only 1 billion USD came into Turkey as FDI from January to June. While this is a significant improvement on the abysmal FDI level of the first half of 2003, it falls far short of the 3 billion in portfolio investment that came into Turkey in January-June. The remainder of Turkey's capital inflow came from bank and non-bank borrowing, while government borrowing was negative because of net repayments to the IMF. Bender analysts Murat Gulkan and Emin Ozturk concur that dependence on portfolio investment leaves Turkey vulnerable to sudden shifts in sentiment (the maxi-devaluation scenario which briefly spooked the markets when it was raised by a Moody's senior credit officer), but they also saw positive financial developments on the horizon that should help cover the gap. These include the recent agreement between the Cukorova Group and the Savings Deposit Insurance Fund (SDIF), whereby the group will repay 4 billion USD over the next two years, almost exclusively from (admittedly mysterious) foreign sources, privatization or sale of big ticket items such as Tupras, Telsim, and Petkim (which should bring foreign interest), and prospects for a new stand-by agreement with the IMF.

¶4. (SBU) Unavoidable Result: Analysts also reminded us that given the nature of the Turkish economy, with its dependence

on imported capital equipment, an expanding deficit is an inevitable result of an economic recovery. Akyurek argued that obviously a current account deficit of 5 percent of GDP would not be sustainable, but that similarly the economy could not grow with a deficit at its post crisis levels of 1.5-2 percent of GDP. Citibank Treasury Vice President Cem Koksal similarly viewed the deficit as a sign of the "success" of the government's economic program, and predicted that government measures would be successful in controlling it.

¶5. (SBU) A Demand Explosion?: Though concern has been raised recently about the dramatic expansion in consumer loans and credit card debt, most analysts, like Deputy Prime Minister Sener, were reluctant to attribute the deficit to credit expansion. Citibank noted that while they have increased, the absolute level of consumer loans is not that high, while Garanti Bank Vice President Kubilay Cinemre argued that automotive loans, one of the fastest growing items, simply represent the fulfillment of pent-up demand from the post-crisis period, and are rapidly reaching their limit. Similarly, Murat Ucer of Eurosource saw signs in July consumer data that consumption is starting to ease, while Global's Akyurek stressed that except for consumer durables, for which demand also accumulated in the post-crisis period, demand pressures are not excessive.

¶6. (SBU) Government Policy: While some, particularly in the banking sector, are critical of the government's decision to increase the natural resources tax to dampen consumer lending, market analysts like Baturalp Candemir at HC Istanbul were impressed by the government's attention to the current account issue. For the first time, he suggested, the government had taken action before a problem had hit the market. On the other hand, the move is likely to complicate upcoming negotiations with the IMF. IMF Deputy Resrep Christoph Klingen has told Embassy Ankara econoffs that the increase in the resource utilization tax had been taken in defiance of Fund staff, which opposed it as contrary to the GOT-agreed strategy of reducing bank intermediation costs.

¶7. (SBU) More generally, however, there is broad consensus that current account pressures dictate that the government should maintain a tight fiscal policy for the foreseeable future, so most analysts in Istanbul are focused on the upcoming IMF-GOT negotiations. Meeting the government's inflation target is likely to be tough next year, Akyurek suggested, and the government needs to maintain a high primary surplus to keep possible demand pressures under control. Both he and Candemir did not see a 6.5 percent level as essential, but saw room for some give and take so long as the quality of fiscal adjustment is improved and its duration lengthened. Hence a primary surplus of 6 percent could be acceptable to the market, as could exclusion of some investment items from the primary balance, so long as the government made clear its commitment to that level over a number of years. Only such a commitment, Akyurek argued, would permit real interest rates to decline from their current 15 percent level. While some are concerned that such rate declines could further fuel imports, Candemir pointed out that the rates' current high levels themselves help fuel the current account deficit by encouraging short-term capital inflows that keep the Turkish lira overvalued. Note: Istanbul analysts' willingness to contemplate some loosening of the 6.5 percent primary surplus does not take into account the likely resistance from the IMF board to easing the GOT's contribution to the financing gap that the IMF is being asked to fill. End Note.

¶8. (SBU) GOT policymakers clearly remain attuned to the market's concerns about the current account deficit. Both Economics Minister Babacan and Deputy Prime Minister Sener sought to emphasize the government's vigilant attention to the current account issue in public comments on August 25, with Babacan noting that the government will undertake further strong measures to control the deficit if necessary, while downplaying the seriousness of the problem in further comments on August 31. For his part, Sener implicitly gave a green light to gradual devaluation of the Turkish lira, arguing that such a development would inevitably help resolve the problem by leading to a decline in imports and rise in exports.

ARNETT